Airlie Australian Share Fund
(Managed Fund)

A concentrated, active portfolio of Australian equities.
Accessing the Airlie investment team and Magellan's operational and client service capabilities.

Airlie Funds Management

Ticker:AASF

Fund Update: 30 September 2021 ARSN: 623 378 487

FUND FACTS

Investment Objective: To provide long-term capital growth and regular income through investment in Australian equities.

Investment Strategy
- Long only, bottom up specialised and focused Australian equities fund
- Concentrated portfolio of 15-35 stocks (target 25)
- Active, high conviction approach - Airlie's 'best ideas'

Inception Date	1 June 2018	
Benchmark	S&P/ASX 200 Accum. Index	
Portfolio Size	AUD $187.0 million	
Distribution Frequency	Semi-annually	
Management Fee	0.78% p.a. (inclusive of net effect of GST)	
Ticker	AASF	
Tickers	**Solactive**	**ICE**
Bloomberg (AASF AU Equity)	AASFAUIV	AASFIV Index
Thompson Reuters (AASF.AX)	AASFAUDINAV=SOLA	AASFAUiv.P
IRESS (AASF.AXW)	AASFAUDINAV	AASF-AUINAV.NGIF
APIR	MGE9705AU	
Minimum Initial Investment#	AUD$10,000	
Buy/Sell Spread	0.14%/0.14%	

 # only applicable to investors who apply for units directly with the fund

WHY CHOOSE THE AIRLIE AUSTRALIAN SHARE FUND?

- Access to an experienced, proven investment team specialising in Australian Equities, with a long track record of prudent common-sense investing
- A conservative and robust investment process that focuses the team's energies on their best ideas
- The strategy is now available to retail investors for the first time through the partnership with Magellan

PORTFOLIO MANAGERS

Matt Williams
Over 25 years investment experience. Formerly Head of Equities and portfolio manager at Perpetual Investments.

Emma Fisher
Over 9 years investment experience. Formerly an investment analyst within the Australian equities team at Fidelity International and prior to that Nomura Securities.

Visit www.airlieaustraliansharefund.com.au for more information, including: fund performance, unit prices and iNAV, investment insight PDS & forms

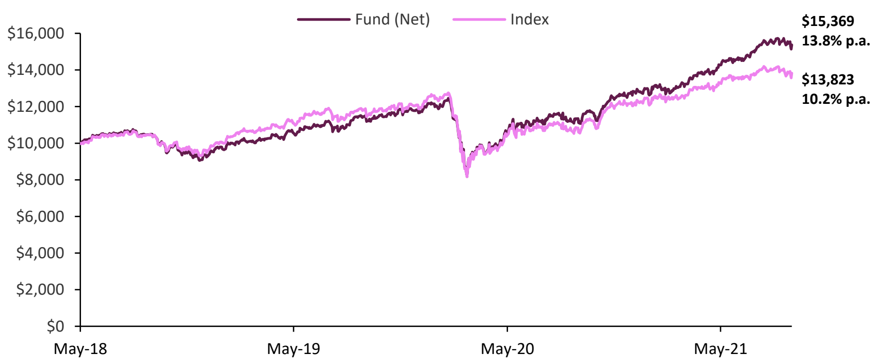
PERFORMANCE*

	Fund (%)	Benchmark (%)	Excess (%)
1 Month	-1.1	-1.9	0.8
3 Months	4.7	1.7	3.0
6 Months	16.6	10.1	6.5
1 Year	38.3	30.6	7.7
3 Years (p.a.)	13.6	9.7	3.9
Since Inception (p.a.)	13.8	10.2	3.6

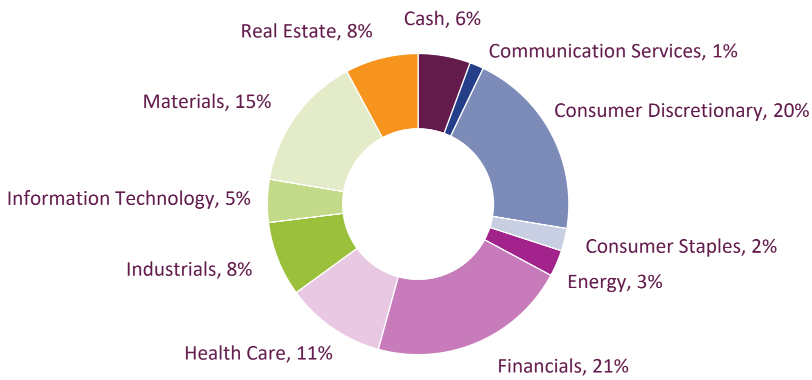
TOP 10 POSITIONS (BY WEIGHT)

Company	Sector**
Commonwealth Bank of Australia	Financials
PWR Holdings Ltd	Consumer Discretionary
CSL Ltd	Health Care
BHP Group Ltd	Materials
National Australia Bank Ltd	Financials
Aristocrat Leisure Ltd	Consumer Discretionary
Macquarie Group Ltd	Financials
Healius Ltd	Health Care
Mineral Resources Ltd	Materials
Wesfarmers Ltd	Consumer Discretionary

PERFORMANCE CHART GROWTH OF AUD $10,000*



PORTFOLIO POSITIONING**



* Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable).Returns denoted in AUD.
** Based on GICS Sector classification, may not sum to 100% due to rounding.

FUND COMMENTARY

The Airlie Australian Share Fund returned 4.7% net of fees for the September quarter, outperforming the S&P/ASX 200 Accumulation Index by 3.0%. Key contributors to the performance included PWR Holdings, which delivered a solid FY21 result and further outlined the long-term opportunity in developing cooling systems for electric vehicles and aerospace applications.

Dicker Data was another strong contributor following the acquisition of New Zealand-based IT distributor Exeed Group. Exeed is based in Auckland and is the second-largest IT distributor in New Zealand (behind Ingram Micro) with revenue of NZ$380 million (split NZ$310 million in New Zealand and NZ$70 million in Australia) and 1,200 reseller partners.

Chairman and CEO David Dicker has noted in the acquisition press release this is a deal he has been trying to pull off for a number of years and that Exeed shares many cultural similarities with Dicker Data: "Their ability to outpace all foreign rivals in their local market is testament to the strength of the business and the team being acquired. The competitive advantage a local distributor brings is deeply ingrained in Dicker Data's DNA, and every reseller partner who works with either business today should be reassured that the seamless continuity of their business is the utmost priority as Exceed is integrated into Dicker Data"

FY21 EBITDA for Exceed is expected to be NZ$15 million so at the purchase price of $68 million (plus working capital) this represents an EBITDA multiple of just five times, boosting Dicker Data earnings by about 15% in year one. While we typically take a sceptical stance regarding the value add of most acquisitions, this deal looks like great value and a good cultural and strategic fit for Dicker Data. Further, we have historically found that acquisitions executed by founder-led businesses tend to have a better track record, as there is usually a stringent focus on price paid, a deep knowledge of competitor businesses and focus on aligning cultures.

Finding opportunity in the noise.

In any given year, a few dominant market narratives surface, taking up newspaper column inches, broker reports, emails (so many emails!) and internet space. Past such narratives include:

• Amazon is about to destroy Australian bricks and mortar retail (2017)

• US inflation is getting out of hand (late 2018)

• The Federal Reserve's tightening has gone too far and must now reverse (early 2019)

• The coronavirus pandemic will cause a global solvency crisis (March 2020)

• Value is now set to dramatically outperform growth (mid-2020).

What is clear from the above is that not all narratives are created equally – they don't always prove to be correct. However, in the heat of the moment they can shift markets with their certainty. There are two current market narratives we have observed dominating headlines and thoughts: the 'reopening trade' (i.e. sell covid-19 winners and buy covid-19 losers that are set to benefit from a normalisation of activity), and the 'inflation debate' (is inflation structural or transitory?)

Why do market narratives emerge? Put simply, this is an industry. People are paid to give their views, and their views must centre around something. So expressed opinions tend to converge on the debate du jour. We do this too. We have participated in panels, discussions, written investor letters (including our most recent annual investor letter) outlining our views on the macro debates or narratives of the day. At times in doing so we have felt inauthentic, worried that we are simply adding our voices to the noise of something that doesn't actually factor heavily into our day-to-day investing process. So we thought we'd use this investor letter to outline why such narratives don't typically play a part in our thinking around investing, with one (important) exception.

The reason we don't position our portfolio to reflect our views on the macro debate of the day is twofold. First, we're not convinced we'd be any good at it. Macro investing is a separate skillset in our minds to long-term equity investing. Our investment process focuses on finding the combination of qualities in companies we have found to make the best long-term investments. However, we don't have a track record (or confidence in) our ability to 'add value' through macro calls, such as positioning the portfolio for a period of significant inflation, or shifting to elevated cash levels to reflect a view that the market is overvalued and will fall in the near term. So we focus on stock picking, rather than layering in macro views that we may or may not get right.

The second reason we shy away from positioning the portfolio around market narratives is simply that they rarely matter in the long run. In the short term, it's hard to predict the direction of a share price: market sentiment, news flow, broker upgrades and downgrades etc. all appear to influence the price. Over the long term, however, we believe only one thing drives the value of a company and that is the returns it generates on the capital invested in the business, so this tends to be our focus.

This isn't to say we don't pay attention to the market narratives. We do, for the simple reason that it is often where the valuation opportunities lie. Once something becomes a dominant narrative, it's usually somewhat in the price. We are reminded of the absolute fire-sale that was Australian listed retailers in 2017, as Amazon prepared to enter the Australian market. JB Hi-fi saw its' share price fall from A$28 to A$22 over the year, Super Retail from A$10 to A$8, Amazon competitor Booktopia was forced to scrap its A$150m IPO – even the mighty Wesfarmers couldn't get its IPO of Officeworks away. Fast forward to today and JB Hi-fi trades at A$46, Super Retail at A$12, Booktopia listed with a A$350 million valuation, and Officeworks EBIT is up 50% from A$144 million in 2017 to A$212 million in FY21.

This didn't occur because the market ended up being wrong about Amazon entering Australia: it did indeed set up direct operations in 2018. However, we have observed the market is often good at predicting the event that will occur, but not so good at predicting what the impact will be. Interestingly, today Amazon is barely raised in companies' Q&A sessions with investors. Perhaps now is the time to pay a little more attention to the issue?

In late 2018, the dominant market narrative was one of rising rates in the US to fight inflation: freight costs were ripping, lumber costs spiked, the US 30-year mortgage rate went from about 3% to nearly 5%. All of this was a perfect storm for sentiment on US-exposed building stocks. The James Hardie share price fell from A$21 in August 2018 to A$15 by January 2019. Again, the market correctly anticipated the event that would occur: the Fed was forced to raise rates aggressively from 1.5% to 2.5% over the course of 2018, however it inaccurately predicted the impact – in fact, the sharp tightening in financial conditions caused by the rate rises led to a precipitous drop in demand and roiled markets, such that the Fed was forced to reverse course in December 2018 and begin cutting rates again. This set the scene for a subsequent global market rally. In hindsight, this was an excellent time to buy James Hardie shares, which have recently topped A$50.

Perhaps the starkest example in recent memory of the market getting this event/impact relationship wrong was the March 2020 coronavirus drawdown. The S&P/ASX 200 fell 30% in 23 days, the fastest ever drawdown of such magnitude. In hindsight, the event the market was anticipating turned out to be entirely correct: a pandemic would lead to the tragic loss of millions of lives, and would cause prolonged global lockdowns, disrupt global travel and supply chains and close international borders. However, the market got the impact wrong. In Australia, rather than economic devastation, the co-ordinated efforts of emergency fiscal and monetary policy drove house prices up over 20% and precipitated among the best economic conditions the nation had seen in decades. It turns out almost every single stock was a buy in March 2020.

So where does this leave us today? While the market narratives (and subsequent mispricing) are not as extreme today as last year, we still consider these as a fertile hunting ground for mispriced assets. At a time where we receive daily emails with lists of 'reopeners' to buy, or warnings on what stocks will be 'hit' as inflation rises, we are given useful clues as to what consensus narrative is being built into expectations, and therefore stock prices. We own a number of 'covid-winners' that such emails would recommend we take profits on, businesses such as Nick Scali, Wesfarmers and Healius. These businesses may have elevated levels of current profit, however this is:

(a) already arguably well understood (e.g. Nick Scali FY22 EPS is forecast to fall 23%, Wesfarmers by 9% and Healius FY23 by 30%);

(b) has underpinned significant balance sheet transformation, which gives latent optionality for capital management to smooth any earnings normalisation. Nick Scali is a great example of this: in the last week its share price has risen over 20% on the announcement that it has acquired Plush Sofas, mostly funded through its significant cash reserves.

On the other side of the equation, this year we have entirely sold out of Qantas, as we believe expectations have run ahead of reality. While we anticipate a return to solid cash-flow generation will follow normalised border arrangements, we believe this cash will fund several years of debt paydown, rather than the years of capital returns we enjoyed as shareholders from 2016-2020.

In short, while the narrative of the day can often seem compelling and inevitable, it rarely matters in the long run for businesses. However, the complex and reflexive relationship between expectations, reality and share prices mean we should regularly force ourselves to lean into that debate to find opportunities to buy good businesses at good prices.

SGH

WesTrac CAT SEVEN WEST MEDIA coateshire

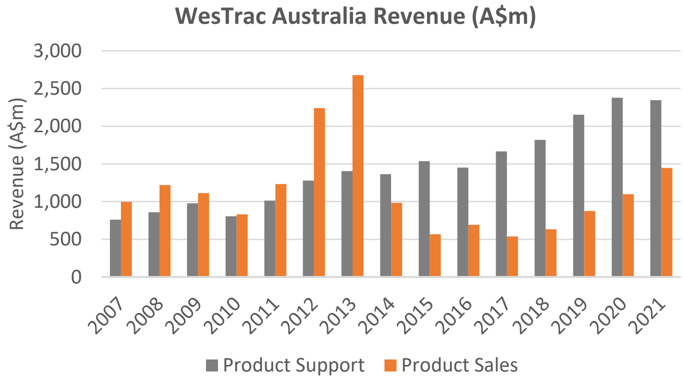
At Airlie, we look to invest in quality companies that we believe are undervalued by the market. Often these opportunities emerge when a great business sits within an otherwise mediocre sector, or when the market assigns an arbitrary discount to a type of business. For us, Seven Group Holdings (SVW) falls into both categories.

Seven is a conglomerate of industrial businesses. Two of these businesses sit in sectors often unloved by investors for their volatile returns and capital intensity – mining services (WesTrac) and equipment rental (Coates). Furthermore, in listed equities 'conglomerate' is a dirty word. It can imply complexity, opacity and bloat, where the corporate structure of the company sits at odds with interest of the shareholders, and many investors choose to avoid conglomerates for these reasons. In our mind, WesTrac and Coates are quality businesses sitting within mediocre industries, pushed further out of sight by the conglomerate structure of Seven. While investors digest the highly publicised on-market takeover of Boral or lament the decline of the namesake Free To Air TV business (Seven West Media), WesTrac and Coates quietly demonstrate their quality and form the majority of our valuation of Seven.

WesTrac – Less cyclical than it appears?

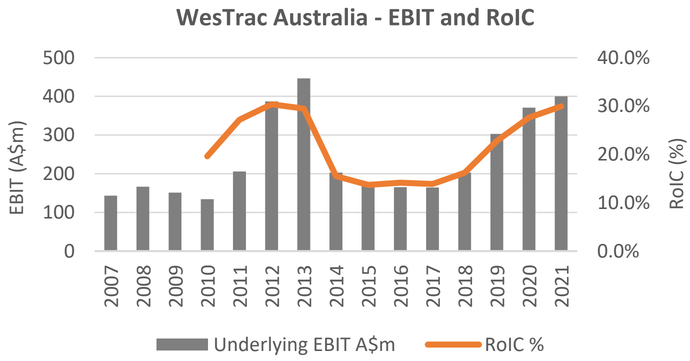
WesTrac is the authorised Caterpillar dealer in Western Australia, New South Wales and the Australian Capital Territory, providing heavy equipment sales and support to customers. Caterpillar employs an independent dealership sales model for its heavy machine sales and support services. Caterpillar thinks this model fosters a stronger relationship between dealers and local customers (acknowledging the importance of high-quality after-sales service and support) and allows Caterpillar to focus its capital allocation on product development and innovation.

WesTrac sales are given in two segments – product sales (i.e. machine sales) and product support. Product sales have been reasonably cyclical, tied to future production volumes and the fleet replacement cycle of the tier-1 and tier-2 miners (and at a second derivative, commodity prices and miner profitability). Product support sales have been far more steady, growing at a 10-year rate of 7.0%, as new sales enter the maintenance program and old equipment sees parts intensity increase and its life extended.



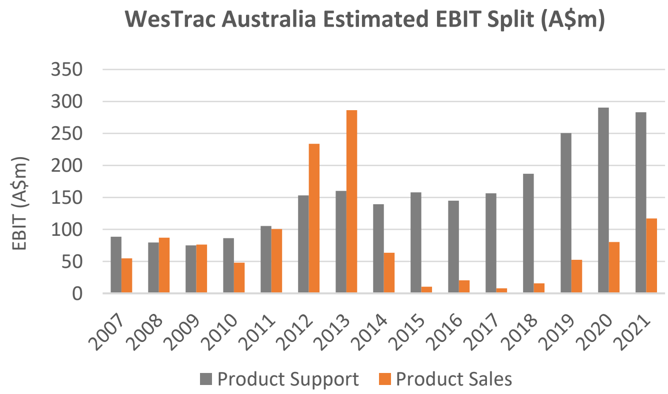
Source: Company data, Airlie

Through the cycle, WesTrac has had a return on invested capital ranging from about 14% (2015, 2016) to 30% (2012, 2021) and EBIT margins between 7% to 11%.



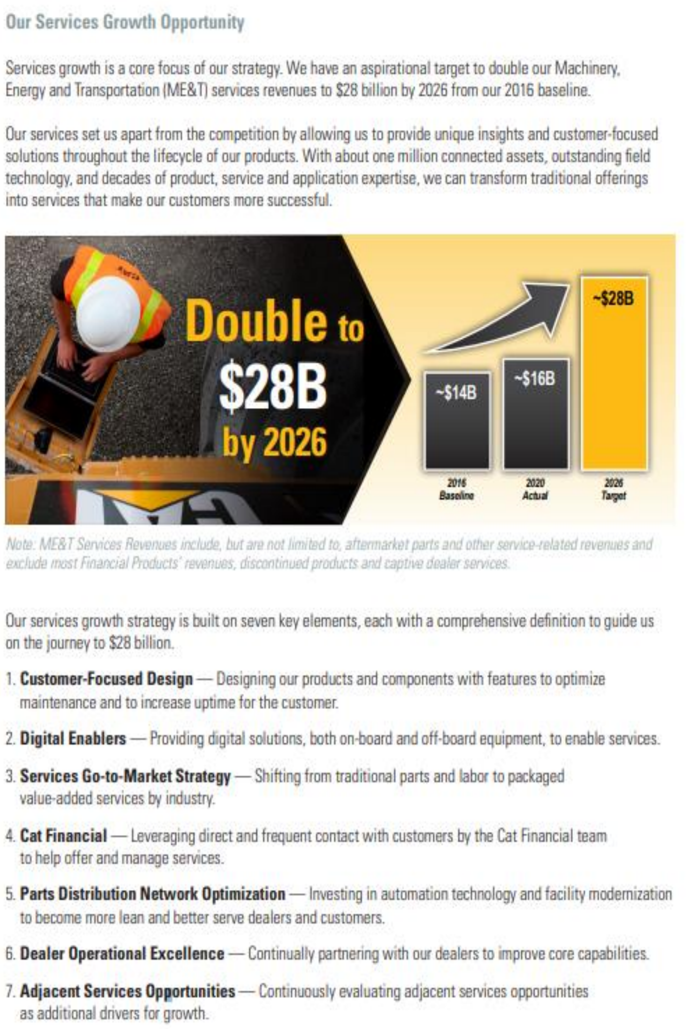
Source: Company data, Airlie

WesTrac does not disclose earnings by segment, but our analysis suggests the earnings of the business have shifted materially towards product support over the past decade. Given product-support revenue is more predictable and still growing, this should mean that even if new sales decline the earnings of the business is more sustainable (versus a decade ago) with arguably a higher 'mid-cycle' earnings base.



Source: Company data, Airlie

Finally, Caterpillar has an internal target of doubling its revenue from product services (via the dealership network) by 2026, as it looks to take advantage of fleet-replacement cycle extensions and expanded product lifecycle offering.


Our Services Growth Opportunity

Services growth is a core focus of our strategy. We have an aspirational target to double our Machinery, Energy and Transportation (ME&T) services revenues to $28 billion by 2026 from our 2016 baseline.

Our services set us apart from the competition by allowing us to provide unique insights and customer-focused solutions throughout the lifecycle of our products. With about one million connected assets, outstanding field technology, and decades of product, service and application expertise, we can transform traditional offerings into services that make our customers more successful.

Note: ME&T Services Revenues include, but are not limited to, aftermarket parts and other service-related revenues and exclude most Financial Products' revenues, discontinued products and captive dealer services.

Our services growth strategy is built on seven key elements, each with a comprehensive definition to guide us on the journey to $28 billion.

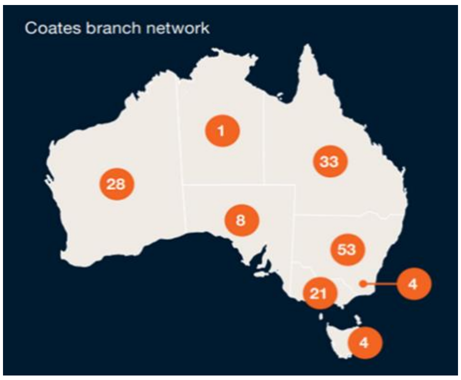
1. **Customer-Focused Design** — Designing our products and components with features to optimize maintenance and to increase uptime for the customer.
2. **Digital Enablers** — Providing digital solutions, both on-board and off-board equipment, to enable services.
3. **Services Go-to-Market Strategy** — Shifting from traditional parts and labor to packaged value-added services by industry.
4. **Cat Financial** — Leveraging direct and frequent contact with customers by the Cat Financial team to help offer and manage services.
5. **Parts Distribution Network Optimization** — Investing in automation technology and facility modernization to become more lean and better serve dealers and customers.
6. **Dealer Operational Excellence** — Continually partnering with our dealers to improve core capabilities.
7. **Adjacent Services Opportunities** — Continuously evaluating adjacent services opportunities as additional drivers for growth.

Source: https://s25.q4cdn.com/358376879/files/doc_downloads/2021/06/2020-Cat-Databook-v2.pdf

The net of this is that we believe WesTrac is far less cyclical than typical mining-services businesses, and earns stronger returns through the cycle, and should be valued as such.

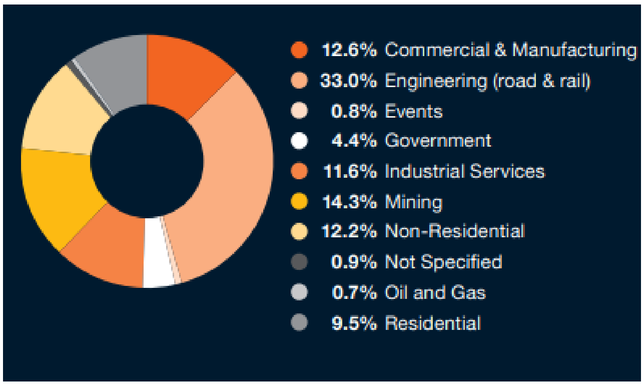
Coates – Impressive transformation ahead of a revenue inflection?

Coates Hire is Australia's largest general equipment hire company and provides a range of general and specialist equipment to a variety of markets including engineering, building construction and maintenance, mining and resources, manufacturing, government and events. The business is primarily exposed to east coast infrastructure, industrial and residential projects, as well as resources activity.

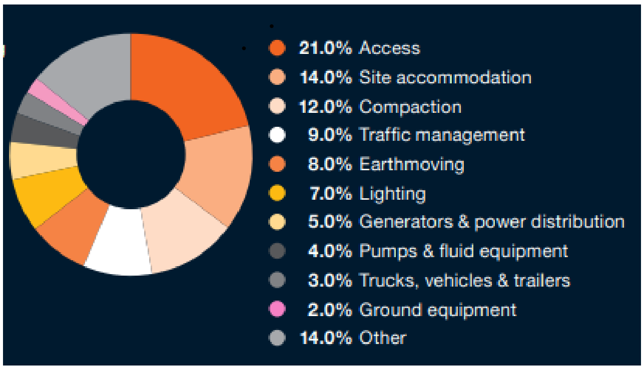


Source: Company data, Airlie

Breakdown of revenue by industry user group (%)



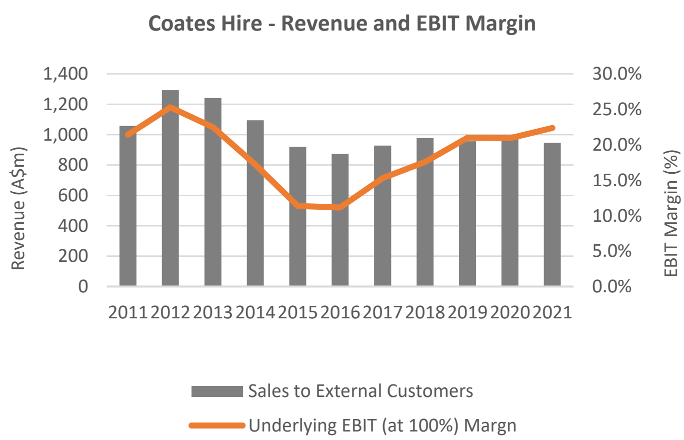
Coates Assets (%)



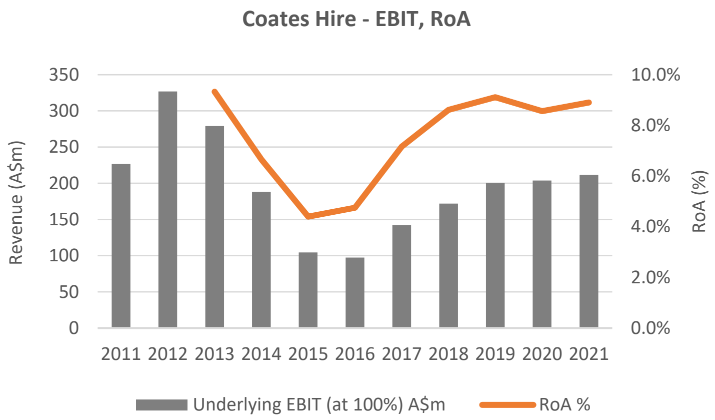
Source: Company data, Airlie

The Coates business is thriving. Following the resources boom earlier in the decade, Coates' margins slumped from about 25% to about 11% as revenue fell from about A$1.3 billion to A$870 million (-32%) from FY12 to FY16. Management has since undertaken a material cost-out, transformation program that has been delivered incredibly successfully:

- In FY15, Coates delivered A$104 million of EBIT on A$919 million of revenue (11.4% margins). In FY21, on essentially flat revenue (A$946 million), Coates delivered A$212 million of EBIT (22.4% margins)
- Since FY15, EBIT has grown at a CAGR of 12.5%, while revenue growth has been benign at a CAGR of 0.5%.



Source: Company data, Airlie



Source: Company data, Airlie

For FY22, management has guided to high single-digit EBIT growth. Looking further out, management is driving the business towards the internal 'Team25' project goals. Team25 is a continuation of the existing transformation strategy within Coates with the business targeting A$1.25 billion of revenue and a 25% EBIT margin. Part of the success of the Team25 targets will rely on revenue growth driven from increased market share and east coast infrastructure spend, however cost-out initiatives still form part of the strategy. Were management to successfully execute on the Team25 targets, Coates would deliver about $313 million of EBIT, versus A$212 million in FY21 (+48% overall, or a 10% CAGR to FY25).

The takeaways for us are two-fold:

- First, Coates management has built an impressive track record of cost management and margin growth in a benign revenue environment; and
- Second, given the above, Coates should see material operating leverage in its earnings should revenue start to grow

Coates' margins and returns sit in the top-quartile of the global equipment rental sector, and there remains the potential for considerable earnings growth over the next two to three years (on top of that delivered steadily since 2016). Both of these factors suggest to us that the business is of higher quality than most would expect of typical rental equipment companies.

Valuation

Of course, Seven does not just consist of WesTrac and Coates. Within the conglomerate also sit stakes in listed companies Boral (70%), Beach Energy (30%) and Seven West Media (40%), as well as unlisted energy, media and property holdings. Of these investments, the recently acquired 70% stake in Boral is the most material (and where valuation is arguably most up for debate). Including the Boral investment, we estimate Seven is trading on a P/E multiple of sub 14x FY22 earnings, which is about a 25% discount to the S&P/ASX 200, and in our mind an undemanding valuation.

In our 'sum of the parts' analysis of the business, we see upside to the current share price when taking a more mid-cycle view of the earnings of WesTrac and Coates, and before including any material valuation upside to the Boral business, should management successfully execute the transformation program and unlock additional value in the non-core property portfolio. Finally, our confidence in the conglomerate structure comes back to ownership. Seven remains 60% owned by the Stokes family, with Kerry Stokes in the chairman role and his son Ryan as CEO. In our view this gives shareholders significant alignment with the board and management, and we have found that through time founder-led businesses tend to consistently outperform the broader index.